**SAI KRIPA**
**Accounting Theory**

**By:- CA Rakesh Kalra**

## INTRODUCTION OF ACCOUNTING AND ACCOUNTING PROCESS

### 1. ACCOUNTING: -

Accounting is Recording Financial Transactions, Summarising them and communicating the financial information to users (i.e. Proprietors, Creditors, Investors, Government agencies, researchers, Consumers, Public etc.). It is because of these characteristics that accounting is necessary for each and every enterprise and now it becomes the Language of Business.

*"Accounting is the art of recording, classifying and summarising in a significant manner and In terms of money; transactions and event which are, in part at least, of a financial character, and interpreting the result thereof."* **Issued by Terminology of the American Institute of Certified Public Accountants**

### 2. ACCOUNTING CONCEPTS

There are Ten Accounting concepts which everyone has to follow while maintaining books of accounts of the Business. These Accounting Concepts are universally applicable, and accepted by all accounting Institutes. These are back bone of Accountancy, they are as follows: -

**Business Entity Concept: -** According to this concept business is considered separate from its business man. All transactions are viewed and recorded in the books of accounts from the Business point of view and not business man point of view. For Example- amount invested by Mr X a business man in his Firm XYZ Limited will be viewed and recorded from the XYZ Limited's point of view and not from X's point of view, so such amount will become liability of the business and business has to show such liability in his Balance Sheet.

**Money Measurement Concept: -** According to this Concept only those transaction are recorded in the books of accounts which can be measures in terms on money only and those transactions which are not measures in terms of money are not recorded in books of accounts. This concept states that money is the common denominator in recording all transaction. For Example- suppose business has 50,000 kg of raw material or it has 65,000 square feet of land that in books of accounts only their monetary value will be shown i.e. they will be converted into money terms.
This concept has limitations also as it is not recorded those transactions which are not in money terms however it effected routine work or profitability of business such as- suppose there will be a fight between management and worker and due to this factory remain close for 2 months, this will affect the profitability of business but it cannot be recorded anywhere as management Fight cannot converted in term of money.

**Going Concern Concept: -** According to this concept it is assumed that business will continue for an indefinite period and there is no intention to close the business or scale down its operation significantly. For Example- Because of this concept Business will consider for purchasing long term assets like Land, Machinery, Plant, etc. this concept will assume that business man will run the business in future and will not have any intention to make his production down.

SAI

**Accounting Period Concept: -** According to this concept the indefinite life of business is broken into smaller period generally one year to measure its performance i.e. to calculate profit. This concept states that as per going concern concept the life of business is indefinite, but the performance of the business will be measures in one year intervals.

**Cost Concept: -**This concept is for assets of the company, according to this concept all assets are recorded it the books of the accounts at the value which are spend for its purchase that is assets are recorded at purchase cost of it and same will be reduced for the depreciation point of view, suppose a firm purchased Land for Rs 1500,000 and Depreciation of land is Rs 100,000 so at the end of the year Land will be show in Balance sheet at Rs 1400,000 (1500,000 – 100,000). This concept has one limitation also that it will not consider market value of assets it recorded assets on historical cost only for example- If in above example such land is purchased in year 1990 than in Balance Sheet it will be recorded at Purchase cost reduced by depreciation however its market value on present date is Rs 75,00,000.

**Dual Aspect Concept: -** According to dual aspect concept, every transaction entered into enterprises must have two effects. These two effects must be of equal amount For Example- Mr X invested Rs 500,000 in his business XYZ Limited, this transaction will also recorded with effects such as Capital of the Business will increases and Assets (cash) will also increase.

**Revenue Recognition Concept: -** According to these concept Revenue will be Recognised/ considered when transaction is entered and obligation to receive payment is arises, For Example- if goods are sold in the month of March but its payment received in August than the Revenue is recognised in March i.e. when transaction of sale occurred and legal obligation to receive amount is arises.

**Matching Concept: -**According to matching concept all the cost which is incurred to earn the revenue should be recognised as expenses in the period when revenue is recognised. For Example- Rs 25000 is spend to make the sale of goods whose income is recognised in next year than such expenses will be considered to be the expense of next year and in current year it will become prepaid expense and show in Balance sheet as Assets.

**Accrual Concept: -**As per this concept, a transaction is recorded at the time when it take place and not when the settlement take place. For Example- Mr X Purchased a Car on May 2009 but its payment was made on December 2009 than in such case Car will be recorded in balance sheet of X as Assets on May 2009 as Computer become assets of X on May 2009 with legal obligation.

**Verifiable Objective Concept: -** This Concept states that Accounting should be free from all personal bias. All accounting transaction should be evidenced and supported by business documents. For Example- Sale should be recorded only if there are Sales invoices/ bills.

**Convention of full disclosure: -** According to this convention there should be complete and understandable reporting on the financial statement of all the significant information relating to the economic affairs of the business.

**Convention of Consistency: -** According to this convention, any accounting practise once adapted and selected should be applied consistently year after year. This convention helps in making financial statement capable of being comparable from previous year to current year.

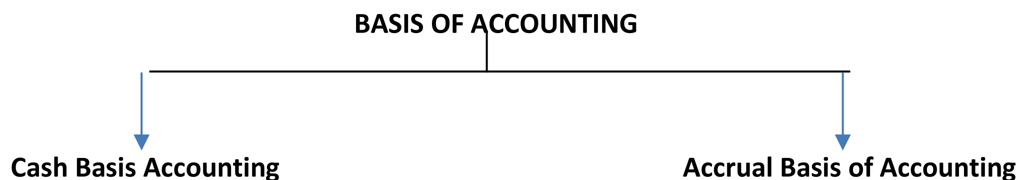
SAI

**Prudence Concept: -** This Concept states that financial statement must present a realistic picture of enterprises, it can easily understandable with English saying that *"Do not anticipate a profit, but provide for all possible losses"* and *"it takes into consideration all prospective losses but not the prospective profits/gains."* It is also known as Conservatism approach or conservatism state of mind.

**Materiality Concept: -** Material Concept states that item or event must be disclosed in financial statement only if it is material. The term material means important nature of such event, materiality define by American Accountant association that "an item is regarded as material if there is a reason to believe that knowledge of it would influence the decision of investors." For Example- An event of spending an amount of Rs 500,000 paid for repair of Plant & Machinery where the Business has Sales of Rs 350,000 only however same event will become immaterial for the business were Sales are Rs 50,00,00,000/-

## 3. BASIS OF ACCOUNTING

One of the basic functions of accountancy is to provide information related to profit earned by a business enterprise during an accounting period. There are two methods for preparing financial statements and calculating profit of the period such as: -




**Accrual Basis Accounting: -** Under Accrual basis of accounting all the Accounting concepts like Revenue Recognition, Accrual concept and matching concept are applied. Under this system of accounting Incomes and Expenses are recorded when they are due actual receipt or payment of money is irrelevant in such system.

**Cash Basis Accounting: -** This is a system were the transactions are recorded only when cash is paid or received by/to the business. Under this system there is no concept of Accrual or Matching concepts, here transaction are recorded only when Cash paid or received. For Example- an amount of Rs 25,000 is paid for rent of next year but it will recorded as expenditure in a year in which it is paid not when the benefit realise from it. Suppose a Sale of goods were made on 2009 but its amount were received in 2010 than it will considerbeing the Income of the year 2010.

SAI

## 4. Financial Statements

The aim of accounting is to keep systematic records to ascertain financial performance and financial position of an entity and to communicate the relevant financial information to the interested user groups. The financial statements are basic means through which the management of an entity makes public communication of the financial information along with selected quantitative details. All the entities will prepare financial statements viz., balance sheet, profit and loss account, cash flow statement etc. by following various accounting concepts, principles, and conventions which have been already discussed in detail.

**Qualitative Characteristics of Financial Statements**

**Understandability:** An essential quality of the information provided in financial statements is that it must be readily understandable by users. For this purpose, it is assumed that users have a reasonable knowledge of business,

economic activities and accounting and study the information with reasonable diligence. Information about complex matters that should be included in the financial statements because of its relevance to the economic decision-making needs of users should not be excluded merely on the ground that it may be too difficult for certain users to understand.

**Relevance:** To be useful, information must be relevant to the decision-making needs of users. Information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations.

**Reliability:** To be useful, information must also be reliable, Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.

**Comparability:** Users must be able to compare the financial statements of an enterprise through time in order to identify trends in its financial position, performance and cash flows. Users must also be able to compare the financial statements of different enterprises in order to evaluate their relative financial position, performance and cash flows.

**Materiality:** The relevance of information is affected by its materiality. Information is material if its misstatement (i.e., omission or erroneous statement) could influence the economic decisions of users Investors.

**Completeness:** To be reliable, the information in financial statements must be complete within the bounds of materiality and cost. An omission can cause information to be false or misleading and thus unreliable and deficient in terms of its relevance.

5. **Capital Expenditure V/S Revenue Expenditure**

Revenue expenditures are transferred to profit and loss account in the year of spending while capital expenditures are transferred to profit and loss account of the year in which their benefits are utilised. Therefore we can conclude that it is the time factor, which is the main determinant for transferring the expenditure to profit and loss account. Also expenses are recognized in profit and loss account through matching concept which tells us when and howmuch of the expenses to be charged against revenue. However, distinction between capital and revenue creates a considerable difficulty. In many cases borderline between the two is very thin.

The basic considerations in distinction between capital and revenue expenditures are:

**Nature of business:** For a trader dealing in furniture, purchase of furniture is revenue expenditure but for any other trade, the purchase of furniture should be treated as capital expenditure and shown in the balance sheet as asset. Therefore, the nature of business is a very important criteria in separating an expenditure between capital and revenue.

**Recurring nature of expenditure:** If the frequency of an expense is quite often in an accounting year then it is said to be an expenditure of revenue nature while non-recurring expenditure is infrequent in nature and do not occur often in an accounting year. Monthly salary or rent is the example of revenue expenditure as they are incurred every month while purchase of assets is not the transaction done regularly therefore, classified as capital expenditure unless materiality criteria defines it as revenue expenditure.

**Purpose of expenses:** Expenses for repairs of machine may be incurred in course of normal maintenance of the asset. Such expenses are revenue in nature. On the other hand, expenditure incurred for major repair of the asset so as to increase its productive capacity is capital in nature. However, determination of the cost of maintenance and

SAI

ordinary repairs which should be expensed, as opposed to a cost which ought to be capitalised, is not always simple.

**Effect on revenue generating capacity of business:** The expenses which help to generate income/ revenue in the current period are revenue in nature and should be matched against the revenue earned in the current period. On the other hand, if expenditure helps to generate revenue over more than one accounting period, it is generally called capital expenditure.
When expenditure on improvements and repair of a fixed asset is done, it has to be charged to Profit and Loss Account if the expected future benefits from fixed assets do not change, and it will be included in book value of fixed asset, where the expected future benefits from assets increase.

**Materiality of the amount involved:** Relative proportion of the amount involved is another important consideration in distinction between revenue and capital.

**Example 1**

State with reasons whether the following statements are 'True' or 'False'.

i. Overhaul expenses of second-hand machinery purchased are Revenue Expenditure.
ii. Money spent to reduce working expenses is Revenue Expenditure.
iii. Legal fees to acquire property is Capital Expenditure.
iv. Amount spent as lawyer's fee to defend a suit claiming that the firm's factory site belonged to the plaintiff's land is Capital Expenditure.
v. Amount spent for replacement of worn out part of machine is Capital Expenditure.
vi. Expense incurred on the repairs and white washing for the first time on purchase of an old building are Revenue Expenses.
vii. Expenses in connection with obtaining a license for running the cinema is Capital Expenditure.
viii. Amount spent for the construction of temporary huts, which were necessary for construction of theCinema House and were demolished when the cinema house was ready, is Capital Expenditure.

**Example 2**

State with reasons whether the following are Capital or Revenue Expenditure:

i. Expenses incurred in connection with obtaining a license for starting the factory for ` 10,000.
ii. ` 1,000 paid for removal of Inventory to a new site.
iii. Rings and Pistons of an engine were changed at a cost of ` 5,000 to get fuel efficiency.
iv. Money paid to Mahanagar Telephone Nigam Ltd. (MTNL) ` 8,000 for installing telephone in the office.
v. A factory shed was constructed at a cost of ` 1,00,000. A sum of ` 5,000 had been incurred in the construction of temporary huts for storing building material

**Example 3**

State with reasons, how you would classify the following items of expenditure:

i. Overhauling expenses of ` 25,000 for the engine of a motor car to get better fuel efficiency.
ii. Inauguration expenses of ` 25 lacs incurred on the opening of a new manufacturing unit in an existing business.
iii. Compensation of ` 2.5 crores paid to workers, who opted for voluntary retirement.

**Example 4**

Classify the following expenditures and receipts as capital or revenue:

i. ` 10,000 spent as travelling expenses of the directors on trips abroad for purchase of capital assets.
ii. Amount received from Trade receivables during the year.
iii. Amount spent on demolition of building to construct a bigger building on the same site.
iv. Insurance claim received on account of a machinery damaged by fire.

SAI

**Example 5**

Are the following expenditures capital in nature?

i. M/s ABC & Co. run a restaurant. They renovate some of the old cabins. Because of this renovation some space was made free and number of cabins was increased from 10 to 13. The total expenditure was 20,000.
ii. M/s New Delhi Financing Co. sold certain goods on installment payment basis. Five customers did notpay installments. To recover such outstanding installments, the firm spent ` 10,000 on account of legal expenses.
iii. M/s Ballav & Co. of Delhi purchased a machinery from M/s Shah & Co. of Ahmedabad. M/s Ballav & Co. spent ` 40,000 for transportation of such machinery. The year ending is 31st Dec, 2019.

**Example 6**

Classify the following expenditures as capital or revenue receipt or capital orrevenue expenditure:

i. Traveling expenses of the chief executive officer for trips abroad for purchase of capital assets.
ii. Amount spent on making a few more exists in a Cinema Hall to comply with Government orders.
iii. Insurance claim received on account of inventory damaged by fire.
iv. Amount paid for removal of stock to a new site.
v. Cost of repairs on second-hand car purchased to bring it into working condition.

**Example 7**

Classify the following expenditures as capital or revenue expenditure:

i. Insurance claim received on account of inventory damaged by fire.
ii. Amount spent as lawyer’s fee to defend a suit claiming that the firm’s factory site belonged to the plaintiff’s land.
iii. Travelling expenses of the chief financial officer on trips abroad for purchase of special machinery.
iv. Dividend received from XYZ limited during the year.

**Example 8**

Classify the following expenditures as capital or revenue expenditure:

i. Expenses incurred to keep the machine in working condition.
ii. Registration fees paid at the time of purchase of a building.
iii. Expenses incurred for advertisement in newspaper.
iv. Amount spent on renewal fee of patent rights.
v. Cost of repairs on second-hand car purchased to bring it into working condition.

**Example 9**

Classify the following expenditures as capital or revenue expenditure:

i. An extension of railway tracks in the factory area.
ii. Amount spent on painting the factory
iii. Payment of wages for building a new office extension.
iv. Amount paid for removal of stock to a new site.
v. Rings and Pistons of an engine were changed to get full efficiency

**6. <u>Contingent Assets</u>**

SAI

A contingent asset may be defined as a possible asset that arises from past events and whose existence will be confirmed only after occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise
As per the concept of prudence as well as the present accounting standards, an enterprise should not recognise a contingent asset.

7. **Contingent Liability**

a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise.
An enterprise should not recognise a contingent liability in balance sheet, however it is required to be disclosed in the notes to accounts, unless possibility of outflow of a resource embodying economic benefits is remote

8. **Provisions**

Provision means "any amount written off or retained by way of providing for depreciation, renewal or diminution in the value of assets or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy".

9. **Accounting Policy**

Accounting Policies refer to specific accounting principles and methods of applying these principles adopted by the enterprise in the preparation and presentation of financial statements. Policies are based on various accounting concepts, principles and conventions.
There is no single list of accounting policies, which are applicable to all enterprises in all circumstances. Enterprises operate in diverse and complex environmental situations and so they have to adopt various policies.

**Selection of Accounting Policy**

It is believed that no unified and exhaustive list of accounting policies can be suggested which has universal application. Three major characteristics which should be considered for the purpose of selection and application of accounting policies.

- Prudence
- Substance over form
- Materiality.

The financial statements should be prepared on the basis of such accounting policies, which exhibit true and fair view of state of affairs of Balance Sheet and the Profit & Loss Account.

**Change In Accounting Policy**

A change in accounting policies should be made in the following conditions:

- It is required by some statute
- For compliance with an Accounting Standard.
- Change would result in more appropriate presentation of financial statement.

10. **Ture And False**

1. The concept helps in keeping business affairs free from the influence of the personal affairs of the owner is known as the matching concept.
2. Entity concept means that the enterprise is liable to the owner for capital investment made by the owner.
3. Accrual means recognition as money is received or paid and not of revenue and costs as they are earned or incurred.

SAI

4. The Conservatism Concept also states that no change should be counted unless it has materialized.
5. The concept of consistency implies non-flexibility as not to allow the introduction of improved method of accounting.
6. The materiality depends only upon the amount of the item and not upon the size of the business, nature and level of information, level of the person making the decision etc.
7. The nature of business is not an important criteria in separating an expenditure between capital and revenue.
8. Expenditure incurred for major repair of the asset so as to increase its productive capacity is Revenue in nature.
9. Amount spent as lawyer's fee to defend a suit claiming that the firm's factory site belonged to theplaintiff's land is Capital Expenditure.
10. Amount spent for replacement of worn out part of machine is Capital Expenditure.
11. Legal fees to acquire property is Capital Expenditure.
12. Amount spent for the construction of temporary huts, which were necessary for construction of thecinema house and were demolished when the cinema house was ready, is Capital Expenditure.
13. A contingent liability need not be disclosed in the financial statements.
14. A Provision fails to meet the recognition criteria.
15. A claim that an enterprise is pursuing through legal process, where the outcome is uncertain, is a contingent liability.
16. When it is probable that the firm will need to pay off the obligation, this gives rise to Contingent liability.
17. Present financial obligation of an enterprise, which arises from past event is termed as contingent liability.
18. There is a single list of accounting policies, which are applicable to all enterprises in all circumstances.
19. Selection of accounting policy doesn't impact financial performance and financial position of the business
20. A change in accounting policies should be made as and when business like to show result as per their choice.
21. Choosing FIFO or weighted average method for inventory valuation is selection of accounting policy.
22. Selection of an inappropriate accounting policy decision will overstate the performance and financial position of a business entity every time.
23. Goods worth ` 600 taken by the proprietor for personal use should be credited to Capital Account.
24. M/s Raj Yog & Co. runs a cafe. They renovated. some of the old cabins. Because of this renovation some space was made free and number of cabins was increased from 25 to 28. The total expenditure incurred was ` 50,000 and was treated as a revenue expenditure.
25. If the amount is posted in the wrong account or it is written on the wrong side of the account, it is called error of principle.
26. Depreciation is a non-cash expense and does not result in any cash outflow.
27. A Partner has his own Goodwill.
28. Goodwill is intangible asset therefore it cannot be valued.
29. Fees received for Life Membership is a revenue receipt as it is of recurring nature.
30. When shares are forfeited, the share capital account is debited with called up capital of shares forfeited and the share forfeiture account is credited with calls in arrear of shares forfeited.
31. Prior period items need not be separately disclosed in the current statement of profit and loss.
32. "Salary paid in advance" is not an expense because it neither reduces assets nor increases liabilities.
33. If the effect of errors committed cancel out, the errors will be called compensating errors and the trial balance will disagree.
34. The sale value of by-product is credited to Trading Account.

SAI

35. Net income in case of persons practicing vocation is determined by preparing profit and loss account.
36. Partners can share profits or losses in their capital ratio, when there is no agreement.
37. The financial statement must disclose all the relevant and reliable information in accordance with the Full Disclosure Principle.
38. The debit notes issued are used to prepare Sales Return Book.
39. Bank reconciliation statement is prepared to arrive at the bank balance.
40. If Closing Stock appears in the Trial Balance then the closing inventory is not entered in Trading Account. It is shown only in the balance sheet.
41. Depreciation is a non-cash expense and does not result in any cash outflow.
42. Discount at the time of retirement of a bill is a gain for the drawee.
43. In case the due date of a bill falls after the date of closing the account, the interest from the date of closing to such due date is known as Red-Ink interest.
44. A withdrawal of cash from the business by the proprietor should be charged to profit and loss account as an expense.
45. Partners can share profits or losses in their capital ratio, when there is no agreement.
46. Fees received for Life Membership is a revenue receipt as it is of recurring nature.
47. Debenture interest is payable after the payment of preference dividend but before the payment of equity dividend.
48. The gain from sale of capital assets need not be added to revenue to ascertain the net profit of a business.
49. Sale of office furniture should be credited to Profit and Loss Account.
50. A partnership firm can acquire fixed assets in the name of the firm.
51. Debenture holders enjoy the voting rights in the company.

SAI